Supreme Court, U.S.
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No. 86-44

IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

SHEARSON/AMERICAN EXPRESS INC. and
MARY ANN MCNULTY,

Petitioners,

v.

EUGENE MCMAHON, JULIA MCMAHON, individually and as trustees of THE DAVID J. HODDER & SON, INC. EMPLOYEE PENSION PLAN; THE DAVID J. HODDER & SON, INC. PROFIT SHARING PLAN; THE LAURIE FUNERAL HOME, INC. EMPLOYEE PENSION PLAN; and THE LAURIE FUNERAL HOME PROFIT SHARING PLAN,

Respondents.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

SUPPLEMENTAL MATERIAL FOR RESPONDENTS

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U.S. House of Representatives
Committee on Energy and Commerce
Room 2125, Rayburn House Office Building
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SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

February 11, 1987

The Honorable John S.R. Shad
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Chairman Shad:

Pursuant to Rules X and XI of the Rules of the U.S. House of Representatives, the Subcommittee on Oversight and Investigations is conducting an inquiry into the adequacy of the current self-regulatory system and the Commission's oversight thereof in connection with complaints against broker-dealers for securities-law violations. We are particularly concerned about increasing numbers of complaints in connection with churning and violations of suitability requirements, as well as complaints that arbitration procedures are rife with conflicts of interest (since the arbitrators are peers of the brokerage firm being sued) and are inadequate to enforce the statutory rights of customers against broker-dealers.

This issue is receiving broad national attention.

On January 4, 1987, CBS "60 Minutes" did a segment on an 84-year-old widow named Mrs. Evelyn Anderson whose Paine Webber stockbroker put her into index options in violation of suitability requirements and churned a $321,262.00 account down to $820.00. She filed a lawsuit against Paine Webber and the broker claiming that, in a six-month period in 1984, they

lost approximately $200,000.00 of her estate and generated commissions in excess of $90,000.00. Like many customers, she signed a mandatory agreement waiving the right to sue in federal court and agreeing to settle disputes in arbitration. Mrs. Anderson's case went to arbitration and, after attorney's fees and expenses, she received only $125,000.00 of her losses back.

On December 3, 1986, the *Miami Review* carried an article, "Securities Safeguards: How Secure?," that reported on a $47 million dollar lawsuit by investors whose accounts were churned and placed in unsuitable and highly-leveraged government bond trades by two Dean Witter Reynolds Inc. brokers, John Kenning and John Carpenter. The article states that the scheme grew because two self-regulatory organizations (SROs), one brokerage house, and the SEC did not act on the information they had: all had knowledge of serious allegations against Kenning three years before the SEC finally filed suit. The Commission's Associate Regional Administrator passed the buck to the industry: "...the responsibility...is...up to the brokerage industry to supervise their employees and to make sure people...are adequately trained and adequately supervised."

Five months ago, however, the General Accounting Office (GAO) reported a sharp increase, from 375 in 1982 to 551 in 1983 and 528 in 1984, in securities law violations committed by broker-dealers that were not detected by the SROs. "Securities Regulation: Securities and Exchange Commission Oversight of Self-Regulation," GAO/GGD-86/-83 (September 1986). Some of those missed violations were serious and the GAO report noted: "While some of the violations were missed for understandable reasons such as violations missed through human error, some were caused by more disturbing reasons such as inadequate SRO procedures." GAO report, p. 21. The GAO found "unexperienced examiners and relatively low salary levels at SROs" as well as "weaknesses in examination procedures, misapplication or apparent unfamiliarity with rules, and errors by individual examiners." GAO report, pp. 24-25. The report said that the Commission is referring more responsibility to the SROs notwithstanding that "Commission regional offices considered the SROs to

be less able than the Commission to identify and take effective action on sales practice cases." GAO report, p. 62.

For the years 1985 and 1986, please identify the number of complaints received by the Commission and the SROs in connection with possible churning or suitability violations, how many of these complaints resulted in investigations and their status, how many resulted in SEC enforcement action or SRO disciplinary action, how many were dropped and who made that decision subject to what guidelines, how many were referred to arbitration and, of these latter, how many resulted in findings for the investor and how many for the brokerage house.

The Subcommittee is informed that the Commission has submitted an *amicus curiae* brief on the side of the securities industry rather than investors in the Supreme Court case *Shearson/American Express, Inc. and Mary McNulty v. Eugene McMahon, et al.*, No. 86-44 (1986) concerning whether antifraud cases brought under the Securities Exchange Act of 1934 and the Racketeer Influenced and Corrupt Organizations Act are barred by predispute agreements between brokers and their customers to arbitrate disputes arising out of those contractual relationships. The Commission's position is a reversal of the position the Commission took in a 1975 case in which the SEC said arbitration could not be used to settle fraud claims under Section 10(b) of the 1934 Act and Rule 10b-5 thereunder.

Furthermore, the Commission's brief in the McMahon case argues the *expansiveness* of the SEC's post-1975 regulatory authority and that arbitration is adequate to enforce the firm's duties because:

> ...since 1975 the Securities and Exchange Commission has had extensive authority to oversee and to regulate the arbitration procedures prescribed by stock exchanges and other self-regulatory organizations for use by members (such as petitioner Shearson) in disputes with their customers. See Section 19 of the Exchange Act, 15 U.S.C. 78s. This regulatory authority, as its

> exercise to date demonstrates, can ensure that such arbitration procedures are adequate to protect statutory rights.

Yet, time and time again, the Commission has advised the Committee of serious *limitations* on your authority and in the arbitration process itself. For example, an August 1986 report prepared by the staff of the Commission's Division of Market Regulation stated:

> *The Commission has no authority to review a specific arbitration to assure either compliance with the procedural requirements of the Code or accurate interpretations of underlying federal securities law or other claims by the arbitrators.* The Commission has no authority to overturn an arbitration award, just as it cannot do so in other private dispute resolutions, such as civil litigation. (p. 3)

* * *

> Arbitrations have historically been considered to be private dispute resolution forums. They have not been open to the public, arbitrators generally do not provide written opinions explaining their awards and the awards are generally not known to the public unless disclosed by the parties. (p. 5) (emphasis added)

Please provide the Subcommittee with copies of any documents, memoranda, or notes which discuss, analyze, memorialize, evidence or otherwise relate to the Commission's position on this matter in connection with the 1975 case and its current position in the McMahon case. Advise us of any legislative or regulatory changes you deem appropriate to improve the arbitration process and your oversight thereof.

We would appreciate receiving your response by the close of business on Friday, April 24, 1987. If you have any questions, please contact Michael F. Barrett (225-4441) or Consuela M. Washington (225-2927) of the staff.

Thank you for your cooperation.

Sincerely,

s/
JOHN D. DINGELL
Chairman
Subcommittee on Oversight and Investigations

cc: The Honorable Edward J. Markey
The Honorable Norman F. Lent

Dated: New York, New York
March 2, 1987

Respectfully submitted,

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